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REPLY BRIEF

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I. REVENUE REQUIREMENT

A. Test Year Profits

The Postal Service revenue requirement discussion in its initial brief attempts to justify its proposals as necessary to meet the financial and other policy goals for the future in order to meet its responsibility to customers and the nation.¹ Surprisingly, the Postal Service is absolutely silent on the most significant revenue requirement issue—whether the Postal Service test year profits projected by OCA on the basis of the record require rejection of the rate increase.

An initial brief filed jointly by AMMA, *et al.* suggests that OCA's argument to reject the rate filing is insufficient because earnings for the full year are not yet available.² This is not a basis for rejection of the OCA position. The Postal Service estimates are also based on FY 1998 projections and they are much older. In fact, actual earnings have already rendered stale the Postal Service projections. The earnings through A/P 6 differ significantly from the amounts budgeted by the Postal Service.³ Further, the Commission regularly updates for actuals. On the other hand, the OCA projections offered in the Response to NOI No. 5 on February 13, 1998, and in its Initial Brief I, remain on target. The recent A/P 6 earnings were \$78 million⁴ and at \$148 million above the budget for the accounting period remained consistently above the FY 1998 budgeted amount. Following is an update of the graph included in the OCA Initial Brief I, but including the results of A/P 6. The revised graph continues to demonstrate the precarious Postal Service position taken in this case that it should be authorized to

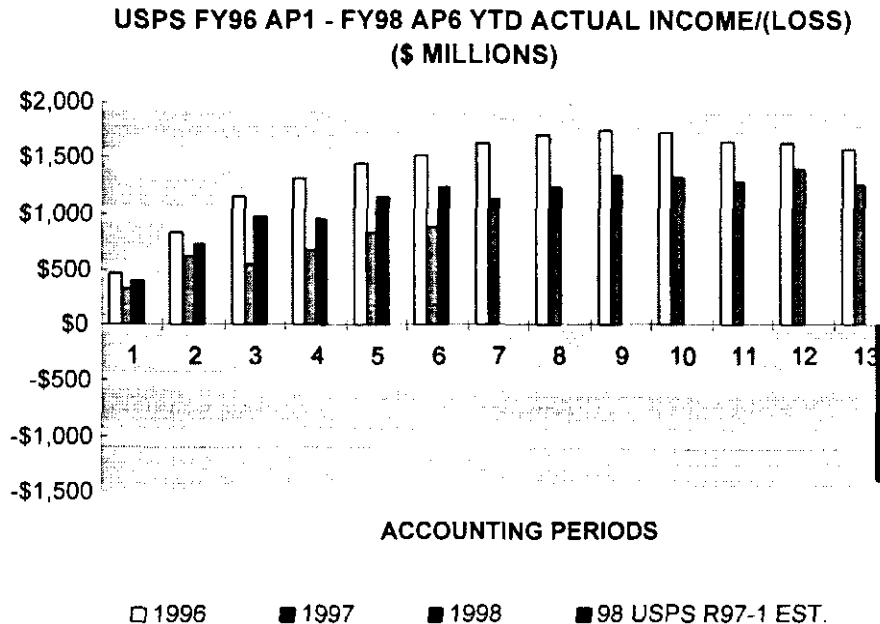
¹ Brief at I-1-9.

² First, the FY 1998 data, even for the accounting periods that have been concluded, is preliminary and since that data represents approximately one-half of the Test Year, incomplete at best. Joint Brief of AMMA, *et al.* at 4.

³ We are unable to say the actual FY 1998 earnings differ from the rate filing because the Postal Service did not deem it necessary to estimate test year projections by accounting period in its rate filing. Even though the Postal Service routinely prepares a budget by accounting periods for its own use and the use of Congress, surprisingly, Rule 54 of the Commission's rules does not require the Postal Service budget to be included with its rate filing.

⁴ Tr. 35/18604.

increase rates by \$1.4 billion for a test year operating deficit plus additional amounts for the contingency and RPYL.



Witness Porras stated accounting period earnings are available about one week after the end of each accounting period.⁵ The bottom line A/P 7 earnings for the period ending March 27, 1998 should now be available at the Postal Service and the detail will be available by April 17 or April 24. Even A/P 8, ending April 24,⁶ bottom line earnings should be readily available two weeks later on May 8, 1998, just before the target date for the Commission decision. We reiterate the motion in our Initial Brief I that the Commission take official notice of the A/P 7 earnings to use in its decision.⁷

Also, the Postal Service record of projecting earnings for the last few accounting periods has been dismal.⁸ The lack of final FY 1998 actuals is therefore not grounds for rejecting OCA's recommendation.

The question of fact before the Commission is whether the test year earnings projection of the Postal Service is likely. Do the Postal Service projections justify

⁵ Tr. 35/18651-2.

⁶ *Id.* at 18650.

⁷ OCA Initial Brief I at 8, n. 20.

⁸ See OCA Initial Brief I at 18-20 and Tr. 35/18636.

extracting \$2.447 billion annually from the mailing public at a time when the Postal Service is prosperous and concerned about losing its customer base through electronic diversion?⁹ OCA believes the earnings projection is highly unlikely and sees no justification for the rate increase. Even AMMA, *et al.*, which does not object to a rate increase, does not believe the Postal Service projection. AMMA, *et al.* states:

First, we, along with virtually all other parties to this case (and probably the Commission itself) are convinced that there is no need for the Postal Service to increase its rates immediately after the Commission issues its recommended decision as has been its historic practice, and the Postal Service probably will not need the additional revenues it seeks in this proceeding until the end of the fiscal year, at the earliest.¹⁰

If the Postal Service does not require a rate increase to meet test year expenses as AMMA *et al.* states, then there is no need for a rate increase. The Postal Service fails to answer any of these questions in its initial brief.

B. Postal Service Revenue Requirement Justifications Are Fallacious And Insufficient.

We now address the few revenue requirement points the Postal Service did present in its initial brief. The Postal Service contends the Commission should accept its revenue requirement because it reflects the Postal Service financial and policy goals. It proudly announces it has "modified its historic approach to ratemaking" as a result of its recent successes and sought a "moderate overall set of rate increases well below inflation."¹¹ The Postal Service further states that if it had deferred the rate request or

⁹ See, e.g., Direct Testimony of Postal Service witness Fronk (USPS-T-32) at 35. ("...it appears that electronic diversion is a real threat to through-the-mail bill payment.")

¹⁰ Joint Brief of AMMA, *et al.* at 2. The several parties joining AMMA in their skepticism about the Postal Service's projected losses are: The Direct Marketing Association, Mail Order Association of America, ADVO, Inc., Saturation Mail Coalition, Nashua Photo, Inc., District Photo, Inc. Mystic Color Lab, Seattle Filmworks, Inc., Val-Pak Direct Marketing Systems, Inc., Val-Pak Dealers' Association, Inc. and Carol Wright Promotions, Inc. Each of these parties has been well represented by counsel throughout this proceeding. Their collective judgement as to the credibility of the Postal Service's revenue requirement claims should carry significant weight.

¹¹ Brief at I-2.

used a later test year, it would not have met the needs of its mailers by filing for smaller increases rather than filing later for "dramatic increases that would be difficult to absorb...."¹²

The Postal Service contentions are beside the point and are fallacious. First, there is no suggestion the Postal Service should have waited to file a rate increase if it truly needed a rate increase at this time. Second, there is a fallacy in its argument. The Postal Service assumes a delay in its rate filing would necessarily result in higher rates at a later date. However, if the Postal Service had delayed its filing or selected a later test year, the recent actual data reflecting a lower revenue requirement than proposed in the filing would be included in the newly proposed rates. The revenue requirement and therefore the rate request would certainly be lower. Also, if the Postal Service selected a later test year, the requested rates based on a later test year would not have been higher. Common sense suggests they would be lower. This was acknowledged by the Postal Service memorandum which states that a "complete revenue requirement update...would probably result in a further reduction in test year costs."¹³

If the Postal Service selected FY 1999 as the test year, the filing would have been delayed pending the availability of the required actuals for the base year, FY 1997. Selection of an FY 2000 test year would require waiting until the base year FY 1998 actuals were available at the beginning of 1999.¹⁴ Rates proposed on the basis of either of those test years would have been lower than proposed here.¹⁵ The unanticipated FY 1997 earnings together with the favorable FY 1998 results would lead to a lower rate increase request.

Further, the Postal Service argument implicitly suggests that if the present requirement is not approved, the next rate filing will include a "jump" in rates. This is not true. If the Commission finds the revenue requirement is less than the Postal Service claims, there will not necessarily be a jump in the rates the next time rate increases are

¹² *Ibid.*

¹³ Tr. 35/18730.

¹⁴ Rule 54(f)(1). 39 C.F.R. § 3001.54 (f)(1).

¹⁵ Again, the Postal Service memorandum referenced above assumes this. Tr. 35/18730.

requested. Assuming the revenue requirement is now correctly calculated to be lower than proposed in this proceeding, then any future increase in the revenue requirement above present levels would be, *ceteris paribus*, lower than otherwise by a like amount. A later filing would involve cost increases starting at a lower base-level revenue requirement so that a later rate increase would not involve a rate jump. If the actual data for FY 1997 and at least part of FY 1998 were included in a later rate filing, the rates requested would have been lower.

In fact, the Postal Service assumption that a rate increase in the near future will be required is not necessarily true. Several favorable factors are converging which could allow the maintenance of current rate levels for several years. First, there may be a sustained level of expenditures on new programs slightly less than projected in FY 1998, commencing with the shortfall in planned expenditures in FY 1998, as we have noted at length in our previous briefs. The Postal Service has not projected FY 1999 new program expenditures in this record but they will not necessarily be higher than in FY 1998. They could well be lower than FY 1998, a time when the Postal Service is trying to gear up its increased investment plans. Second, the benefits of automation and other investments will improve the earnings of the Postal Service. These benefits are already accruing according to the Postal Service and were the source of their ability to delay their filing for this rate cycle. These benefits should grow in proportion to the increased investments made this year. Third, the unanticipated volume increases in FY 1997 will probably be sustained as the economy continues at a higher level of output than previously seen and the Postal Service enters new markets. Fourth, in only three years, or even less, the prior year losses will be recovered if earnings continue at current levels and the need for \$377 million annually will be immediately eliminated. Fifth, as the Postal Service continues to strengthen financially, removes its past year losses, and pays down debt, the amount deemed reasonable for the contingency will be lower. At the risk of overstating the financial potential for the Postal Service and expressing a level of confidence in the Postal Service management which they do not echo, it is entirely possible that if these factors together fell correctly into place they could very well eliminate the immediate need for a rate increase in the next few years and make obsolete the concept of a regular cycle for rate increases. Accordingly, the claim that the

Postal Service revenue requirement ought to be accepted by the Commission because it is lower than the Postal Service might otherwise have requested is contrary to recent cost, revenue and other Postal Service financial history.

Also in support of its proposed revenue requirement, the Postal Service contends "the current rate and revenue proposals reflect decisions regarding expenditures deemed to be critical to the future viability, growth, and continued financial success of the Postal Service."¹⁶ OCA would expect nothing less--that at the time of filing the Postal Service believed these planned expenditures were important, and that, unless it notifies the Commission to the contrary, continues to believe that is the case. But that is not the issue here. Neither OCA nor any other party has ever suggested the Postal Service's planned expenditures should be cut back, voluntarily or otherwise. We have only argued that the planned rate increase should be cut back because the current rates return sufficient revenue for the amount of expenditures which can be reasonably expected.

The planned Postal Service spending increases are unusually large. For instance, cost segment 16 expenses (supplies and services) are planned to increase over the two year period, FY 1996 through the test year, by 43.73 percent.¹⁷ Cost segment 20 expenses (depreciation, write-offs, claims, and interest) are planned to increase by 24.46 percent.¹⁸ The increase in supplies and services and depreciation costs are due to the operating and capital investment programs and are not driven by increases in mail volume.¹⁹ The spending increases in these cost segments are therefore within the greater discretion of the Postal Service.

On its face, such large spending increases in the above cost segments raise questions as to the ability of the Postal Service to expand at that rate. The record demonstrates the Postal Service will not and possibly cannot expand so quickly. On the other hand, OCA has *not* opposed the rapid expansion of expenditures in these cost segments. OCA contends only the Postal Service will not be able to expediently

¹⁶ Brief at I-2-3.

¹⁷ Tr. 9/4478.

¹⁸ *Ibid.*

¹⁹ *Id.* at 4478-9.

undertake all of its planned expenditures. The test year expenses and the rates should be based on reality, not hope. If the Postal Service has a profit in the test year, as OCA pointed out in the first section of its initial brief, then it follows the Postal Service has sufficient revenues for its needs during the test year and no rate increase is required. Alternatively, even if the Commission finds there may be a test year revenue deficit, the issue is whether the Postal Service deficit will be as large as projected. OCA's Initial Brief II does not urge any forced cut-backs in planned expenditures, but explains why the projected deficit will be significantly less than estimated.²⁰

The Postal Service also issues a tardy plea that the Commission act "as a partner with the Postal Service in fulfilling the nation's needs for a progressive postal system."²¹ This request strikes a hollow note. Just one month ago on March 4, 1998, the Postal Service did not choose to recognize its own partnership responsibilities. The Postal Service rejected the Commission's letter offer dated February 24, 1998, to move as partners to determine the impact actual figures would have on the cost and revenues in this case. The Postal Service rejected a legitimate request to work within the intent of the Postal Reorganization Act. On the other hand, the Postal Service now implicitly suggests the Commission act as a partner to conspire to subvert the specific break-even provision of that statute. That is not a partnership intended within the spirit of that legislation.

The Postal Service also points to its several recent operational successes as an impetus for future spending plans. Many of these successes are those which OCA has pointed to as the probable basis for the Postal Service's recent favorable earnings. Interestingly, the Postal Service recognizes that the benefits of its financial success enabled it to defer the rate increase filing in this case. It says its success has contributed to rate stability, "An extended rate cycle and improved service tend to enhance the value of postal products; this in turn engenders mailer confidence and further stimulates volume growth."²² We could not have said it better. Any delay in rate increases will

²⁰ OCA has argued there should be no allowance for witness Porras' additional ADP Year 2000 expenses. OCA primarily contends that, on the basis of the record, the funds will not be spent and that the Postal Service is unable to spend them during FY 1998; not that the programs should be cut back.

²¹ Brief at I-3-4.

increase volumes and therefore revenue and earnings. This is precisely why the Commission can and should recommend no rate increase at this time and why we believe the sky would not fall in on Postal Service earnings if there is no rate increase at this time.

Finally, the Postal Service points to witness Porras' concern over "the possibility of negative consequences which followed Docket No. R90-1" if the Commission does not refrain from updating for known changes.²³ The Commission must not be deterred by past errors in estimating the break-even level of the Postal Service costs and revenues. The Commission still has the duty to make a best estimate of the revenue requirement on the basis of the record before it. Even if miscalculations were made in Docket No. R90-1, it does not follow that the Commission must never again attempt to estimate the Postal Service revenue requirement. The statutory obligation of the Commission to determine the break-even point has not been altered since that decision in Docket No. R90-1. Also, even in Docket No. R90-1, the contingency included in the revenue requirement covered the miscalculation.²⁴ Likewise, the projections here indicate that a more than sufficient amount is available for a contingency. Moreover, even though the contingency proposed is smaller here than it was in Docket No. R90-1, the Postal Service is in a much better financial position than it was in 1992 and the general financial outlook is stronger.

C. The AMMA *Et Al.* Proposal To Implore The Board Of Governors To Delay A Rate Increase Is Infeasible And Contrary To The Postal Reorganization Act.

AMMA, *et al.* incorrectly argue that retention of the 32 cent First-Class stamp, while increasing the rates for other classes, "ignores entirely the cost and non-cost factors of Section 3622(b)."²⁵ OCA does not ask that the section be ignored. The Commission must and can comply with the terms of the statute and still retain the 32 cent

²² Brief at I-5.

²³ Brief at I-8-9. See *also*, Porras testimony regarding Docket No. R90-1, Tr. 35/18589-91.

²⁴ Tr. 35/18591 and 18597.

²⁵ AMMA, *et al.* brief at 3.

First-Class rate. The difficulties presented by the 1 cent increment limitation for the First-Class rate prevents the Commission from raising all rates by a consistent amount where the revenue requirement is, as we have pointed out, below the threshold amount. Many of the participants who are commercial mailers do not object to a rate increase on the basis of this record. OCA, representing the interests of many First-Class stamp users, opposes the proposed increase. It would be equitable to implement a rate increase to recover a reduced revenue requirement deficiency from those classes not objecting to the new rates.

The AMMA, *et al.* solution recognizes that the entire rate increase, if any, is not required at this time. Rather than rejecting the rate increase or recommending smaller increases, AMMA, *et al.* would have this Commission recommend virtually the entire increase. It does not concern itself with the niceties of the statute that require reference to the break-even requirement. AMMA, *et al.* suggest the Commission implore the Board of Governors not to implement the full rate increase "until the facts show that the Postal Service needs the additional revenues."²⁶ First, isn't that what this case is all about? Second, OCA has not seen any signals from the Board of Governors that this suggestion is feasible or that it would adequately protect against the Board imposing the rate increase immediately on the First-Class mailers who are least represented and subject to the Postal Service monopoly.

As recently as March 9, 1998, at a Las Vegas, Nevada speech, Postmaster General Runyon stated that he intends to place the new rates into effect as soon as June, 1998.²⁷ Furthermore, the Board has unfettered discretion as to the implementation date of the new rates. The Commission's duty is to determine the rates which meet the statutory requirements. The rates proposed by the Postal Service do not meet those requirements. It is unreasonable to expect the Commission to pass on the rate increase and defer to the Board of Governors the burden of determining just when the proposed rates will meet the statutory break-even level. The rate filing and all filings since that date have all indicated the Board of Governors believes the statutory showing

²⁶ *Id.* at 7.

²⁷ Tr. 35/18664.

has been made for those rates to become effective immediately. Also, the example the AMMA, *et al.* points to of the Board taking to heart Commission suggestions is not in point. The Board previously took the Commission's suggestion to improve its earnings position, certainly a desirable course for the Board. Here, the Commission would ask the Board to defer rate increases that would lead to excessive earnings. The AMMA, *et al.* example does not demonstrate the Board would delay the opportunity to increase rates as soon as possible consistent with its pleading throughout this proceeding. The AMMA, *et al.* proposal is therefore infeasible, not to mention contrary to the intent of the provisions of the Postal Reorganization Act.

Finally, AMMA, *et al.* also criticizes the OCA comment in its Initial Brief I reminding the Commission that rejection of the rate increase might lead to a request for reconsideration from the Board of Governors. If there were a remand, we noted, this Commission would have most or all of the actual FY 1998 earnings by accounting period available for its consideration. AMMA, *et al.* surprisingly sees this as an "exercise in power politics—in which the Commission seeks to force the Governors to take steps that the Governors are not required to take under the statute."²⁸ To the contrary, OCA is not suggesting that the Commission reject the rate filing merely as an exercise of its authority. The record currently does not support a rate increase. OCA was instead pointing out that if the rates are rejected the Postal Service would still have the opportunity on reconsideration to demonstrate on the basis of actual FY 1998 earnings that the earnings are as they claim. It is a particularly odd assertion that recognizing the Postal Service would have the opportunity to vindicate itself on the basis of actual figures is "power politics." It is merely routine procedure to permit reconsideration at which time all the facts might be considered. The process OCA envisions is more akin to a partnership whereby the Postal Service is given a renewed opportunity to work with the Commission on the basis of actual earnings numbers. This is in stark contrast to the "power politics" of the Postal Service that curtly rejected the Commission letter offer for a similar partnership.

²⁸ Joint Brief of AMMA, *et al.* at 3.

D. ADP Year 2000 Expenses And Other One-Time or Pilot Project Expenses.

The Alliance of Nonprofit Mailers (ANM) raised some thoughtful questions in its initial brief regarding the general ratemaking principle that there be a match between anticipated expenditures and the economic benefits to the ratepayers.²⁹ This point is relevant to the expenditures for "other programs" and particularly relevant to the ADP Year 2000 expenditures. OCA opposes the inclusion of any of the additional \$298 million for the ADP Year 2000 program requested by witness Porras on the grounds that the Postal Service has not demonstrated it will actually make these last minute additional expenses and sufficient documentation was not provided.³⁰

Additionally, the proposed ADP Year 2000 expenses are one-time, front loaded expenses undertaken only during this year and FY 1999, but solely for the benefit of customers after January 1, 2000. The benefits of these expenses will accrue to future customers of the Postal Service in the year 2000 and every year thereafter. Until January 1, 2000, the present Postal Service customers will not benefit at all. On this basis, none of expenditures should be included in the FY 1998 test year. It is inappropriate to allow any of these expenses in determining rates to be effective prior to the year 2000.

Charging current customers for benefits inuring to future customers may discriminate against current customers and this violates a fundamental principle of ratemaking that benefits match expenses.³¹ The test is whether the expense is either annually or periodically recurring, or if non recurring, extraordinary in nature.³² The "other programs" of the Postal Service involve numerous projects of a longer term duration. More significantly, many involve research or pilot projects. For instance, the Postal Service admits the original \$38.2 million Augmented Sales Force Program portion

²⁹ ANM Initial Brief at 5-6.

³⁰ OCA Initial Brief II at 34-7.

³¹ Cf. *Re City of Sheridan*, 17 PUR3d 496,504 (Wy. PSC 1957), *Re Maine Public Service Company*, 12 PUR3d 349, 351 (Me PSC 1956).

³² *Western Mass. Elec. Co.*, 114 PUR 4th 1, 23-24,30-31 (1990) citing *Fitchburg Gas and Electric Light Company*, D.P.U. 1270/1414 pages 32-33 (1983).

of its Tactical Sales Force strategy has been reduced to a \$2 million pilot project and might be cancelled.³³ Witness Tayman stated: "The status of the Augmented Sales Force program is being re-evaluated pending the outcome of a pilot being conducted in the New York Metro Area... In addition to the pilot, the funds have been redirected to other programs such as development of a Manifest Mailing System and Customized Packaging."³⁴ Of the original \$38.175 million set aside for the Augmented Sales Force program, \$19.975 million is now "being held as unallocated funds pending the results of the pilot or possible redirection to some other initiative."³⁵ Without even knowing the outcome of the pilot project, the Postal Service is expensing the project in this rate case and is also including the \$19.975 million as potential expenditures which it is "holding" for "possible redirection."³⁶

The Postal Service has not clearly delineated those expenses relating to pilot projects nor has it justified expensing rather than capitalizing such costs.³⁷ Its compliance with accounting principles does not necessarily mean that for ratemaking purposes it has properly accrued the costs and amortized them appropriately. Before the costs of pilot projects are expensed the Postal Service must justify currently expensing the funds rather than capitalizing them. Further, the Postal Service must indicate which projects are cancelled so that the Commission can determine the proper ratemaking treatment as opposed to accounting treatment.

If a project is constructed, costs are generally capitalized but if a project fails or is discontinued and is not constructed then the costs may be permitted to be amortized in the next rate case.³⁸ Witness Porras admitted that many of the Postal Service projects the Postal Service is expensing have a multi-year payoff.³⁹ Even if projects are cancelled

³³ Tr. 9/4521.

³⁴ Tr. 9/4484.

³⁵ Tr. 9/4521-2, (\$38.175 million -\$2 million -\$16.2 million). See also Tr. 9/4510.

³⁶ See also OCA Initial Brief II at 39 discussing the moving-target aspect of the Postal Service's "other program" expenditures.

³⁷ Tr. 9/4484.

³⁸ Cf. *Nantucket Electric Co. D.P.U.* 88-161/168 page 79 (1989).

³⁹ Tr. 35/18611-13.

or are deemed to provide benefits to future customers, they should be amortized over the period during which the customers may have benefited or will benefit from the expenses. The applicable ratemaking principle is that, "Nonrecurring expenses, if allowed at all for rate-making purposes, are commonly amortized over a reasonable period of years."⁴⁰

For instance, one regulatory agency's rules (FERC) provide that research initiatives must be supported by evidence that the project or program "has a reasonable chance of benefiting the ratepayer in a reasonable period of time."⁴¹ To determine whether a project has a reasonable chance of benefiting the ratepayer special "peer review" is not required to determine whether "efficiency gains...outweigh the costs to ratepayers...." Only that it "by its nature [is] likely to benefit ratepayers if successful."⁴²

The agency need not undertake a "painstaking cost-benefit analysis...on a project by project basis" to determine if a project has a reasonable chance of benefiting ratepayers. Instead the Commission need make "only a candid, common-sense assessment as to the consistency of a project's objectives with the interest of the ratepayers providing the financing."⁴³ Research and development are one of the "unusual settings" which allow "charging to current ratepayers...even though the fruits of those expenditures may flow to future ratepayers."⁴⁴ The ADP Year 2000 program does not fall into the category of research and development. It involves automated data programming expenses which will not benefit current customers.

The period of amortization depends upon the character of the service received or disbursement made.⁴⁵ The ADP Year 2000 expenses will not benefit present mailers but after January 1, 2000 the customers will benefit indefinitely. This argues for a longer period of amortization period rather than a shorter period—at least ten years and

⁴⁰ Garfield and Lovejoy, *Public Utility Economics*, Englewood Cliffs, N.J., Prentice-Hall, 1964, at 47-8.

⁴¹ 18 C.F.R. § 154.38(d)(5)(iii)(d).

⁴² *Process Gas Consumers v. FERC*, 866 F.2d 470, 474 (CA DC 1989). See also, *Mobil Oil Corp. v. FPC*, 417 U.S. 283, 320 upholding FPC authority; *Tennessee Gas Pipeline Co. v. FERC*, 606 F.2d 1094, 1109-14 (CA DC 1979).

⁴³ *Id.* at 477.

⁴⁴ *Office of Consumers' Counsel v. FERC*, 655 F. 2d 1132, 1149 n.32 (CA DC 1980).

⁴⁵ *Driscoll v. Edison Light & Power*, 307 U.S. 104 (1939).

perhaps longer, commencing only with a rate case known to cover the period FY 2000 and thereafter. There are thus numerous reasons for rejecting in this case the Year 2000 expenditures.

On a broader front, the Commission's rate proceedings do not provide a satisfactory forum for maintaining a careful review of the ongoing projects of the Postal Service. The multitude of projects are extremely fluid. New ones are developed and others are altered or cancelled. OCA recommends that the Commission undertake to establish a means whereby the costs and benefits of the projects totaling in excess of \$5 billion this year can be monitored to measure the appropriate capitalization, expensing, and amortization amounts for use in future rate proceedings. Annually, new programs expenses account for almost 10 percent of the total Postal Service expenditures. Common sense suggests that this is an area that should be continually viewed very closely by the Commission to carry out properly its functions under the Postal Reorganization Act.

II. CEM ISSUES

A. The Postal Service's Criticisms Of CEM Are Inconsistent With Its Position On Prepaid Reply Mail.

OCA need not respond at length to the Postal Service's CEM opposition, as expressed in its Initial Brief. OCA's Initial Brief II already offers a point-by-point refutation of the Postal Service criticisms.⁴⁶ However, the Postal Service's arguments in favor of Prepaid Reply Mail ("PRM"), offered as a replacement for CEM, shows striking *inconsistencies in its support for its PRM proposal and its opposition to CEM.*⁴⁷

PRM, according to the Postal Service, avoids the so-called "'two-stamp' problem—the alleged adverse consequences of administering a postal system in which the public would be expected to differentiate its 1-ounce letter mail on the basis of whether it was qualified for either the full basic rate or the discounted CEM basic rate"⁴⁸ Of course, consumers will have to understand that a PRM envelope does not require postage. Moreover, they will have to comprehend that a PRM envelope cannot be readdressed.

In support of PRM, the Postal Service states that "[o]ver two-thirds of those surveyed considered the [PRM] product either 'very' or 'somewhat' attractive."⁴⁹ OCA would point out that, by comparison, over two-thirds, i.e., 68 percent, of persons surveyed in witness Ellard's study were very or somewhat likely to use a CEM stamp if

⁴⁶ OCA Initial Brief II, Section II.

⁴⁷ OCA takes no position on whether or not PRM should be recommended for adoption. We note that the Brief of the Coalition of Mailers Who Provide Courtesy Reply Envelopes states: "The Commission's Office of Consumer Advocate (OCA) appears to urge that the Commission should recommend adoption of both the Service's proposal and OCA's own CEM proposal." *Id.* at 5. OCA stresses that we maintain a neutral position about PRM. However, we do share many of the concerns stated in the Coalition brief about PRM and believe PRM is an inadequate substitute for CEM.

⁴⁸ See Postal Service Initial Brief at V-30. The Postal Service's characterization of confusion occurring as to "1-ounce letter mail" demonstrates the speciousness of its "confusion" argument. Postal Service customers face a wide variety of rates for mail at other weights and for other classes of mail (e.g., parcel post, post cards, Priority Mail, etc.). Even for First-Class letters, they must understand the extra-ounce rate and the non-standard surcharge rate. These rates are far more confusing than CEM (and require mailers to stock stamps of two or more denominations). Yet the Service proposes to retain these complications while opposing CEM.

⁴⁹ Postal Service Initial Brief at V-31.

the discount were three cents.⁵⁰ (OCA believes the discount should be four cents, which might raise the 68 percent figure even higher).⁵¹

The Postal Service also argues in support of PRM that convenience is a primary concern to consumers:⁵²

This research also demonstrates that the key factor when respondents determine how to pay a bill is convenience, not price. Reply mail recipients who expressed an interest in PRM were not influenced by the price, but by the level of convenience—the not having to buy and affix postage stamps—associated with PRM.

As explained in our Initial Brief II, the Postal Service's emphasis on the "convenience" issue is a smokescreen, designed to deflect attention from the obvious fact that consumers like lower prices.⁵³ The Postal Service elsewhere acknowledges the importance of lower prices to consumers, such as in its publication, "A Consumer's Guide to Postal Services and Products."⁵⁴ The first page of the publication notes: "Knowing about the various products and service options the Postal Service offers can help you choose the right service to meet your needs and save you time and *money*."⁵⁵ Prominently displayed in the cardboard insert to the booklet is this assertion: "A First-Class stamp remains a bargain at 32 cents. The cost of mailing a letter in the United States is among the lowest in the industrialized world."⁵⁶ Why would the Postal Service spend the time and ink to print this statement if it really believed price was not an important factor to consumers?

The Postal Service PRM argument continues:⁵⁷

⁵⁰ OCA Initial Brief II, at 68 n. 242.

⁵¹ *Id.*, at 46-47.

⁵² Postal Service Initial Brief, at V-32.

⁵³ OCA Initial Brief II, at 48.

⁵⁴ Publication 201, January 1995. The Commission may take official notice of this publicly available document.

⁵⁵ *Id.* at 1.

⁵⁶ *Id.*, cardboard insert between pp. 18-19.

⁵⁷ Postal Service Initial Brief, at V-32.

Invoices and bill payments are the largest component of the First-Class Mail stream. USPS-T-32, at 35. With the growth in electronic alternatives to the mail stream, it is clear that electronic diversion poses a threat to through-the-mail bill payment. By not requiring that the senders affix postage, PRM provides an opportunity to enhance the convenience of using the mails in a manner which can help to stem the threat of electronic diversion.

OCA pointed out in its Initial Brief II that CEM "addresses the threat of electronic diversion by providing consumers a convenient, but less expensive way to return bill payments by mail."⁵⁸ OCA also observes that the success of PRM to fend off electronic diversion depends on whether or not major CRM providers will use PRM. The outlook for PRM does not look promising, as one can easily discern from the Initial Brief filed by the Coalition of Mailers Who Provide Courtesy Reply Envelopes.

The Postal Service PRM argument continues:⁵⁹

By recognizing some of the cost differences associated with this mail, witness Fronk has further enhanced the appeal of PRM. Proposed in conjunction with a reduced rate of postage, PRM offers an opportunity for household and small business mailers in search of a more convenient way to transact business to do so in a manner which creates an opportunity for them to share in the cost savings associated with automation, without reviving the "two-stamp" problem associated with earlier CEM proposals.

CEM offers the same advantages as PRM, but without the associated high fees. Small businesses will not be able to profitably use PRM unless they have enough mail to overcome the high fees, i.e., the \$1,000 monthly fee means that a mailer needs to save 3 cents—the discount per piece—on more than 33,333 pieces of mail per month in order to break even. OCA believes that consumers are intelligent enough to understand the CEM indicator that will tell them it is permissible to use a discounted CEM stamp—just as they will be able to understand a PRM indicator that no postage is necessary.

These are but a few of the assertions in the Postal Service PRM argument that are virtually identical to arguments that favor adoption of CEM; we eschew a more

⁵⁸ OCA Initial Brief II, at 53.

⁵⁹ Postal Service Initial Brief, at V-32.

detailed analysis in an effort to save a few trees. (OCA believes, however, that CEM is in many ways superior to PRM, as OCA witness Willette outlined in her direct testimony.⁶⁰) Indeed, if OCA had had the Postal Service word processing diskette in hand prior to preparing its own Initial Brief, it might have facilitated OCA's brief preparation, replacing "PRM" with "CEM" and deleting reference to the two-stamp "problem."

The Commission, it should be mentioned, has agreed with the OCA position on the "two-stamp problem":⁶¹

Witness Potter marshals several other arguments against availability of an automation discount to the general public. In the Commission's view, he seriously underestimates the general public's capability to change their mail preparation habits. The Postal Service has numerous means available to it to overcome potential problems with consumer use of a discounted stamp. Also, it is probable that providers of CEM envelopes will assist in the education process to ensure that courtesy envelope mail is used in an appropriate fashion. Likewise, consumers faced with the possibility of a late charge should a remittance be returned for postage due will be motivated to use the discounted stamp only when appropriate.

Perhaps there is some mystery involved in the Postal Service's revival of the "two-stamp" argument (although logic dictates its CEM opposition is driven by the desire to retain monopoly profits). For our last word on CEM, perhaps until the next millennium, OCA "borrows" from an opinion by Judge Frank in the Second Circuit criticizing an Interstate Commerce Commission "valuation" decision.⁶² Merely changing the word "valuation" to "CEM evaluation" and replacing ICC references with Postal Service references produces the following apt criticism of the Postal Service's position on CEM:⁶³

⁶⁰ Direct Testimony of OCA witness Willette, Tr. 21/10696-10713.

⁶¹ PRC Op. MC95-1, at V-35.

⁶² *Old Colony Bondholders v. New York, N.H. & H.R. Co.*, 101 F.2d 413, 450-51 (1947) (Dissenting opinion).

⁶³ *Ibid.* Footnotes in the cited text are from the original document. In the cited text, omphalic inspiration refers to contemplation of one's navel (from the Greek root *omphalos*). Ornithomancy is divination by observing the flight of birds. Haruspication is divining events by interpreting natural phenomena (such as lightning) or basing predictions on inspecting the entrails of sacrificial animals. The phrase "aleatory devices" refers to the use of dice to guide one's actions.

If however, the Postal Service is sustained in this case, and, accordingly, behaves similarly in future cases, then its conduct will indeed be a mystery. Its so-called "CEM evaluation" will then be acceptable, no matter how contrived. In that event, it would be desirable to abandon the word "evaluation"—since that word misleadingly connotes some moderately rational judgment—and to substitute some neutral term, devoid of misleading associations, such as "aluation," or, perhaps better still, "woosh-woosh." The pertinent doctrine would then be this: "When the Postal Service has ceremoniously woosh-wooshed, judicial scrutiny is barred. It would then be desirable to dispense, too, with the Postal Service's present ritualistic formula, "Taking into consideration, etc.," [footnote omitted] replacing it with patently meaningless words, perhaps the same words spelled backward, (i.e., "Gnikat otni noitaredisnoc, etc.").⁶⁴ Then no one would be foolish enough to believe that the figures in a Postal Service plan necessarily have anything to do with deliberation, but everyone would know that the figures might well have been the product of omphalic inspiration,⁶⁵ or ornithomancy, or haruspication, or aleatory devices, and that the conclusions of the Postal Service might well be but the conjurations of mystagogues.⁶⁶

B. The Postal Service's Projected CEM Administration Costs Are Unsupported, And Even If Entitled To Some Evidentiary Weight, Are Flawed.

The Postal Service projects that factoring in education, enforcement and window transaction costs would cause it to incur \$146 million in expenses "in the first year alone."⁶⁷ In its Initial Brief II, OCA argued why the Postal Service cost evidence should be entitled to little or no weight. In short, important portions of the rebuttal testimony

⁶⁴ *** As to the expedient of thus spelling backwards to avoid misleading the reader, see George, *The Scientist in Action* (1938) 109.

⁶⁵ As to the use of the omphalos in oracular activities, see e.g., Harrison, *Themis* (2d ed. 1927) 396-424; Rhode, *Psyche* (transl. 1925) 97, 110, note 31; cf. Gilbert, James Joyce's *Ulysses* (1934) Chap. III.

⁶⁶ Montaigne said of oracular utterances: "But above all, that which gives them the greatest room to play in, is the obscure, ambiguous, and fantastic gibberish of their *** canting, where they deliver nothing of sense, but shroud all in a riddle ***." *Essays*, Bk. I, Ch. 11. [The remainder of the footnote contains a lengthy recitation of a judicial opinion from Rabelais' *Pantagruel*.]

⁶⁷ Postal Service Initial Brief, at V-90-91.

contained cost information which the OCA unsuccessfully had sought to obtain on discovery.⁶⁸ The Postal Service should not be permitted to take advantage of its discovery rules' violations by introducing the previously-sought information on rebuttal. Second, much of the information could not be verified by Postal Service rebuttal witness Miller on cross-examination.⁶⁹ The Postal Service, it should be noted, does not project similar costs for introducing PRM, suggesting that the CEM-related costs are just another part of the Postal Service CEM smokescreen.

However, there are fundamental methodological problems with the Service's CEM costing analysis. According to Postal Service witness Miller, the \$146 million figure is derived from \$33 million in education costs, \$17 million in increased window transaction costs, and \$96 million in revenue protection costs.

As to the education expenses, OCA explained in its Initial Brief that the evidence could not be verified by witness Miller on cross-examination.⁷⁰ We simply know nothing about the details of the media plans, for example. Nowhere does the Postal Service explain why it cannot educate consumers about CEM as an incremental portion of its overall education campaign for other likely fundamental changes in operations that will affect the public after this rate case, such as the introduction of a pack-and-send business, the new PRM rate, and any increase in First-Class rates. Indeed, it strains credulity that the Postal Service will go out of its way to advertise a rate that will reduce its revenues. Likely the education burden will fall on CRM providers anxious to obtain good will from their customers by explaining the new lower CEM rate. Moreover, it is highly doubtful that consumers will need more than a very short period (say, a month) to learn everything they need to know about the simple CEM rate.

The window service costs study has no logical foundation. For example, it assumes CEM transaction costs are all extra costs imposed on the system, without any commensurate decrease in costs associated with regular First-Class postage purchases that would not have to be made because more First-Class mail pieces are using the

⁶⁸ OCA Initial Brief II at 81-86.

⁶⁹ *Id.*, at 86-87.

⁷⁰ OCA Initial Brief II at 86-87.

CEM stamp. What is likely to happen, of course, is that many consumers will simply purchase CEM and First-Class stamps at the same time.⁷¹ The 42 million extra CEM-only transactions forecasted are thus just a fictional estimate.⁷² Thus, to the extent that CEM stamps are purchased, fewer transactions will occur for the purchase of regular First-Class stamps. The result should be a wash. However, to the extent that consumers who ordinarily purchase one book of First-Class stamps at a time now purchase two (one CEM, one regular) total transactions (and total transactions costs) may decrease.

The Postal Service's projected revenue protection costs also are fictitious. The Postal Service does not now employ an army of employees to find the small percentage of underpaid mail that exists. The probable reason for this is the evidence showing that consumers tend to overpay postage rather than underpay.⁷³ Indeed, to the extent household mailers do not want to take the trouble to purchase CEM stamps, they will be giving the Postal Service extra revenues.

⁷¹ If that happens, there may be a few seconds added to an individual window transaction, but certainly not the 54.4 seconds ascribed in Exhibit USPS-RT-17C to a full window transaction. Tr. 33/17496. But even those few extra seconds will not add to total First-Class postage-purchase transaction costs because the total number of transactions will decrease, i.e., there will be fewer trips made to purchase regular First-Class stamps. To put the 54.4 seconds in perspective: how likely is it that purchasing extra-ounce or nonstandard-surcharge stamps in addition to first-ounce stamps requires an additional 54.4 seconds of window time?

⁷² USPS Exhibit RT-17C, Tr. 33/17496.

⁷³ OCA Initial Brief II, at 63-64. The Postal Service assumes a two percent short-payment rate for CEM based on a 7.35% short-payment estimate for First-Class Mail subject to the extra ounce rate. Using extra ounce shortpayment rates to generate a CEM shortpayment estimate is illogical. The CEM envelope will have a conspicuous indicator on it. Consumers will easily be able to tell the difference between a CEM envelope and the regular First-Class Mail envelope, just as they now can easily tell the difference between a CRM piece and a Business Reply Mail ("no postage required") piece. However, one knows from common experience that consumers cannot tell when a mail piece they have prepared weighs more or less than one ounce unless they go out of their way to weigh the piece. OCA thinks many of us have had the experience of guessing at the weight of a First-Class mail piece. With the CEM indicator, there will be no need to guess.

III. UNDUE OR UNREASONABLE DISCRIMINATION OR PREFERENCE

The Postal Service's proposed expansion of parcel post length and girth limitations is unduly discriminatory because it is being offered only to high volume mailers. As noted in OCA's Initial Brief II, OCA contends that the Postal Service's proposal to increase the maximum combined length and girth for Parcel Post from the existing 108 inches to 130 inches is unduly discriminatory because the Postal Service proposal would permit no more than ten percent of the pieces in any mailing to have combined length and girth exceeding 108 inches.⁷⁴ OCA notes that The Parcel Shippers Association ("PSA"), while supporting the proposal, "regrets the Postal Service proposed limitation on what percentage of a mailing may exceed the 108 inch limit, since it does not fully meet our members' needs."⁷⁵ PSA's contention further indicates that the Postal Service proposal is discriminatory, because it does not even meet the needs of all businesses who mail parcels. One can infer that small businesses are especially being shortchanged.

PSA also makes the point that there are only two realistic options available to the public for the delivery of parcels to residences, UPS and the Postal Service.⁷⁶ The point is well made. OCA observes that if business mailers feel affected by the concentrated market for residential delivery, then household mailers would similarly be affected. In short, household mailers have nowhere to turn to, other than to UPS or the Postal Service, for mailing parcels. If the Postal Service proposal is adopted with the subject restriction, household and small business parcel mailers will in effect have only one carrier to turn to for oversized parcels.

⁷⁴ OCA Initial Brief II at 108 *et seq.*

⁷⁵ PSA Initial Brief at 12.

⁷⁶ *Ibid.*

IV. VOLUME VARIABILITY

As stated in the Initial Postal Service brief, witness Bradley's cost variability study attempts to identify the causal relationship between costs and the cost driver.⁷⁷ The Postal Service has succinctly summarized its view of the cost variability study presented by witness Bradley, alleging that all credible evidence suggests that mail processing labor costs are not fully variable with volume.⁷⁸ In fact, as witness Neels and Dr. Smith testified, the study does not succeed in establishing or successfully estimating a causal relationship. The study is based on a flawed application of economic theory. The study focuses on short run rather than longer run costs, has an inadequate estimation procedure, lacks relevant variables, and is based on an inadequate and inaccurate database.

Witness Bradley has noted that the study represents the first time that there has been an attempt to estimate the cost variability of mail processing with respect to volume.⁷⁹ As a first attempt the study has deficiencies which will need to be corrected but could serve as the basis for additional work which ultimately could provide a measurement of cost variability. However, the study in its current form does not meet the accepted standards of reliability for regulatory work as outlined by Dr. Bonbright. For example, the study does not apportion mail processing costs correctly, lacks understandability and feasibility of application, and is still subject to substantial controversy over methodological and data issues.

A. Witness Bradley's Study Is A Short-Run Study Producing Short-Run Cost Estimates, But A Longer Run Analysis Is Needed.

The USPS states that witness Bradley's cost estimating procedure is "appropriately short-run."⁸⁰ The short-run nature of the results is highlighted by a number of the estimating procedures. First, only two variables—TPH and hours—are actually

⁷⁷ USPS Initial Brief III-11.

⁷⁸ USPS Initial Brief III-13.

⁷⁹ USPS-T-14, page 3.

⁸⁰ USPS Initial Brief III-44.

gathered from the postal sites. The data are repeatedly identified as factory floor data, which would appear to exclude the consideration of the longer term factor interactions with TPH and hours that are likely to impact costs over the time period during which rates are in effect. The other variables used in witness Bradley's study are time trends, accounting period delineations, or the results of computations on the TPH variable—none of which are related to actual plans, investments, capacity expansion, or dynamic responses to changing mail volumes.

Accordingly, by ignoring other relevant variables such as capital, capacity, machinery, and technology related variables, witness Bradley has focused on producing a short run study, with an alpha intercept vector to take account of differences between sites. As such, the study is at best a measure of short-run costs, essentially of a one or two period nature, but is based on a data set extending over nine years. The study is short-run because it lacks a measure of capital or other factors which will impact costs over the two to three year time period that the proposed rates will be in effect. Witness Bradley should have modeled costs to show the impact of technological changes; changes in costs as facilities are enlarged, contracted, and eliminated. Alternatively, changes in costs due to other than routine changes in TPH and facility operations, such as variations in capacity could have been used.

Guidance on the types of modeling that should have been used can actually be obtained from the comments of Dr. Panzar:

. . . the marginal costs that will actually be incurred by the firm to serve a sustained increase in volume over the time period during which the prices will be in effect⁸¹

Although Dr. Panzar endorses witness Bradley's approach, a careful consideration of the quote indicates that the relevant costs which Dr. Panzar is discussing are of a longer term nature—the costs which will be in effect for the approximately three years during which rates will be in effect. These costs would be more appropriately modeled using approaches that consider the interaction of the changing facility infrastructure with

⁸¹ Tr. 11/5417.

changing mail-processing demands. Another relevant postal witness on this subject is witness Christensen:

The true difference between short-run and long run costs is that, in a short-run situation (which could be equivalent to any calendar period of time), not all options are available to the firm, while in the long-run, the firm faces fewer constraints on its decisions. Therefore, the difference between the long-run and the short-run is the ability to have greater degrees of freedom in making decisions and deploying resources.⁸²

In view of the USPS major investment programs underway, it appears the longer run will be a time period of up to three years, involving investments in capital and alterations of facilities — not the several months short-term time frame modeled by witness Bradley.

B. Contrary To The Postal Service's Contentions The Absence Of Scale Economies In Mail Processing Is Logical At The Activity Level.

The USPS states:

The absence of economies of scale is not logical, either for industry in general or for the Postal Service in particular.⁸³

While additional mail may be processed on the very short-term basis as discussed by witness Bradley, any sustained increase in mail at the activity level could very well be accompanied by constant returns. This is illustrated by the testimony presented by Postal Service Area Vice-President Steele:

If you walked through and took a snapshot of a bulk mail center platform, you might see an open door as we're waiting for a trailer to back in and see two mail handlers waiting for that truck to be backed in.

A snapshot at that point in time might look like they were not fully occupied, but they're assigned to those doors and waiting for the cycle of trucks in and out.⁸⁴

⁸² USPS Initial Brief III-45.

⁸³ USPS Initial Brief III-22.

⁸⁴ USPS Initial Brief III-21.

Witness Steele was explaining why platform operations should be expected to have a variability below 100 percent. On a short-term basis, one can understand witness Steele's viewpoint. However, witness Steele's example needs to be carried one step further in analyzing the relevant costs on a longer-run basis. Assuming a sustained increase in mail accompanied by, say, one additional door being added to a facility, the Postal Service would presumably have to hire two additional mail handlers to stand by and wait at the additional door, waiting for the cycling of additional trucks. Accordingly, at the activity level—not the plant level but rather the level at which witness Bradley is measuring costs—it is quite reasonable to assume constant returns to scale. One additional door would result in two additional people standing by.

The USPS continues with a quote from witness Stralberg that:

*. . . It is impossible to think of any manufacturing industry where it is not believed that higher volumes will lead to improved efficiency and lower unit costs.*⁸⁵ (Emphasis in original.)

The comment is irrelevant, for no one in this case is examining the industry or factory levels of operations at postal mail processing facilities. Rather, witness Bradley is measuring mail processing at the *activity* level. At the *activity* level, industrial operations in fact do tend to be of a constant scale nature. For example, if one plastics machine with two employees extrudes 3,000 pieces in an hour, two machines with four employees would be required to obtain 6,000 pieces in an hour. In the expansion of factory operations many overheads—e.g., Vice Presidents, night watchmen, human resources and accounting personnel, etc.—may be of a fixed nature and susceptible to economies of scale. In fact, this phenomenon appears to be behind much of the current restructuring of American industry. However, at the *activity* level, factory operations are frequently subject to constant scale returns. Accordingly, the possibility of 100 percent variability at the activity level is not at all inconsistent with industrial operations.

⁸⁵ USPS Initial Brief III-22.

C. There Are Significant Deficiencies In Witness Bradley's Estimating Procedures.

The USPS states:

All credible evidence of record in this proceeding clearly demonstrates that mail processing data costs are not fully variable with volume.⁸⁶

This statement is just plain wrong. Dr. Smith's testimony indicates he disagrees with the above statement, and Dr. Neels has also filed extensive and significant testimony in opposition. The deficiencies in the analysis include (a) the inappropriate application of the fixed effects approach, (b) the lack of adequate consideration of alternative estimating procedures including cross sectional and pooled approaches, (c) the use of time control variables for the analysis of technical change, and (d) a lack of data.

1. The Postal Service fixed effects approach is deficient.

Witness Bradley's fixed effects approach is based on the assumption that the slope of the relationship between hours and TPH for each individual site is identical across sites. This assumption was the subject of analysis in the Commission's Notice of Inquiry No. 4, i.e., whether the slopes were equal by site. Three of the witnesses used an F Test to test the hypothesis of the equality of slopes. There was general agreement that the slopes were not statistically confirmed to be equal. However, a key assumption of witness Bradley's econometric estimating procedure is slope equality. His excuse for this deviation from reality is, in part, that it was necessary to make such an assumption for ease of computation.

The OCA did not present an F test analysis. The OCA did, however, present a "t" test as a site-by-site basis that arrived at the same conclusion: inequalities of slopes. In addition, the OCA found by visual inspection of the data that the data were far from meeting the requirements for the equality of slopes on a site-by-site basis. To be specific, the OCA response to Notice of Inquiry No. 4 found that some of the data were blobs, while other data suggested that a 100 percent variability pooled mode might be

⁸⁶ USPS Initial Brief III-13.

more appropriate even at the site level. The USPS has a remarkable footnote in its initial brief in conjunction with its visual inspection discussion:

It is instructive to contrast Dr. Smith's alleged inability to interpret the time trend coefficients with his vaunted ability to visually inspect data plots for approximately two minutes each and conclude that "they suggest a variability approaching 100 percent for many of the activities." See Tr. 28/15842 and 15920. Dr. Smith could not demonstrate these powers during cross-examination because his powers surprisingly do not extend to plots that exclude the origin.⁸⁷

This comment is misleading. Clearly the plots have to go through the origin for there to be 100 percent variability. The absence of the origin on plots precludes meaningful visual inspection; there is nothing surprising at all in Dr. Smith's testimony.

The above comments are, however, illustrative of the USPS' apparent view that the modeling of the data does not need to comport with the underlying data structure—a requirement that should be intuitively obvious. Dr. Smith's visual inspection of data has been derided as lacking in technical rigor. However, it should be noted, according to the Chairman's Exhibit PRC/UPS-XE-2, that a wide variety of econometric estimated coefficients have been derived—from relatively low variabilities to variabilities well in excess of 100 percent.⁸⁸ Put differently, a group of economists have been unable to agree on the best way to draw a straight line (actually, a plane in hyperspace) through a group of data points. Instead of producing additional econometric results based on the ever expanding econometric literature, Dr. Smith indicated that the USPS in this case needs to focus on the underlying economic theory, the implications for estimation, and the selection of an estimation technique that comports with the data. This would be a fruitful area for further exploration by the Postal Service.

Accordingly, the examination of simple data plots is relevant as well as visually compelling. It should also be noted that although there are a large number of variables in witness Bradley's study, nevertheless, the only two variables *actually gathered* at a postal site are hours and TPH. Accordingly, these are the two important variables of the

⁸⁷ USPS Initial Brief III-42.

⁸⁸ Tr. 28/15785.

study and were the ones that were actually plotted. Although any plot may not be entirely accurate—apparently sharing this characteristic with some of the econometric work—such a plot demonstrates that one would expect to find a high degree of variability.

2. The Postal Service inadequately considered alternative estimating procedures.

The pooled model was dismissed as biased; however, additional variables should have been examined, particularly capital as measured in investment dollars with appropriate depreciation, inflation, and technological considerations. The *reason* that the pooled model was dismissed according to the USPS Initial Brief is as follows:

The pooled model assumes that all sites are identical in the characteristics that determine costs, which is a highly unrealistic characterization of the Postal Service's actual facilities.⁸⁹

The statement on identical characteristics is not true. Witness Bradley eliminated the pooled model, for it did not pass the appropriate statistical analysis as *he tested it*. However, it appears that in witness Bradley's view the primary deficiency of the pooled model was the absence of explanatory variables that would have allowed for differences between sites—variables whose use OCA has advocated and variables which witness Bradley did not use. Accordingly, the pooled model that was rejected was witness Bradley's *limited and inadequate model*—not a correctly specified pooled model with explanatory variables.

If the correct variables had been used (including capital, facility capacity, machine relevant information, etc.), a pooled model approach would have permitted a consideration of the longer-term impacts of the current major technological investment program. It is not at all clear that the pooled model would have been inappropriate.

A second model also dismissed as biased was the cross-sectional model. Because witness Bradley's inadequate initial specification such a model was biased. If he had included the correct variables, it is entirely possible that a cross-sectional

⁸⁹ USPS Initial Brief III-69.

approach would have been appropriate. The cross-sectional model should have been examined in greater detail—again with appropriate consideration of variables.

Both the pooled and cross-sectional models gave different results from those obtained by witness Bradley, appear likely to better reflect the underlying longer-term economics of cost incidence, and need to be further considered and upgraded. OCA is in significant disagreement with witness Bradley's approach.

3. The Postal Service analysis of technological change is deficient.

As the USPS has indicated, the role of the technology change variable is really in the nature of a control variable.⁹⁰ As such, the use of the time trend variable is designed to avoid a biased estimator. However, witness Bradley's analysis provides no adequate explanation of technological change. In fact, the USPS notes that the technology variables could capture effects other than technological change, so there is really no explanation at all. In view of the major changes in equipment, with automation replacing mechanization, and in view of the high level of projected investment, one would expect that changing technology would significantly impact many of the mail processing activities. However, this is not accounted for in the Postal Service study. In addition, the study repeatedly segments the mail processing operations into two distinct time periods: 88-92, and 93-96. There is never any discussion of the real world necessities underlying such a segmentation—another major omission.

4. The Postal Service study suffers from a lack of data.

Witness Bradley's study has a total of 15 variables in the estimating equation for direct activities and 34 variables in the estimating equation for allied activities. However, only two of the variables—hours and TPH—actually are variables physically gathered on site or which in any way directly relate to the activities at the site. All other variables are either derived or relate to generic phenomena—e.g., time periods. The OCA has already focused in its Initial Brief on the limitations of TPH and hours from an explanatory

⁹⁰ USPS Initial Brief III-42-47.

viewpoint and, in general, has already addressed in the Initial Brief Section II the Postal Service's comments in its Initial Brief.

Witness Bradley's study includes many data points from both a time series as well as cross-sectional site viewpoint, but really analyzes only two pieces of data—hours and TPH. Accordingly, Dr. Smith testified the study actually needs more data for explanatory purposes over the relevant time period. For example, witness Bradley has no adequate measure of capital in his work. In what appeared to be a hastily performed analysis provided with his rebuttal testimony witness Bradley provided building age, building square feet of space, and building height data for mail processing facilities as cost drivers. However, none of these variables necessarily has any significant relationship to the actual capital equipment used in a mail processing activity at a facility. For example, the value of an LSM machine is clearly unrelated to the number of stories or age of a building—and only minimally related to the value or amount of the square feet of space in the facility. Yet, we are assured by the Postal Service that the absence of capital from the analysis is not a problem because capital costs are measured in other accounts:

Thus omitting capital variables from a cost equation to determine the variability of mail processing labor costs does not mean that the Postal Service's capital costs are ignored.⁹¹

Actually, in terms of analyzing the impact of capital and changing capital availability on mail processing costs, the absence of capital data does mean that the Postal Service's capital costs are ignored in terms of their impact on postal operations. There is a vast difference between accounting for capital costs and analyzing the impact of modern capital equipment on the need for labor.

From a cost accounting point of view, very clearly capital costs are picked up in other accounts. However, the accrual of costs from an accounting point of view is not the issue. Rather, it would be highly desirable to model the interaction of new capital equipment with labor requirements in the processing of mail. This is exactly what should be the focus of the study. However, for the interaction of capital as well as other possible

⁹¹ USPS Initial Brief III-49.

variables with the demand for labor, one needs to have the variables in the translog cost equation—and they are not.

The focus of the Postal Service's productivity improvement program is the upgrading of efficiency through investment in capital equipment. For example, new and improved electronic, automated sorting is different and superior to mechanized sorting. Accordingly, the introduction of advanced letter sorting machines (LSMs) will have a major impact on the labor requirements in the process. There may be differences in labor requirements between a mechanized LSM machine and an automated LSM machine, and major differences in output. However, witness Bradley's model ignores these differences, other than to possibly change the alpha intercept. Accordingly, witness Bradley's model becomes a very short-term model due to major data constraints.

5. The Postal Service model has major data base problems.

The USPS has indicated that:

The panel data used by witness Bradley are comprehensive and hold advantages over other types of data.⁹²

The statement is wrong. First, as previously noted, the data are not comprehensive. Actually, the panel data consists of only two major variables. Other variables that might be expected to be found in an economic study—e.g., factor prices, capital, machine types if the data are segmented, and other explanatory variables are noticeably absent. We are left with only two variables per site even though there are a lot of observations.

In fact, there is so much data for the two major variables, and it is of such questionable credibility, that witness Bradley focuses largely on eliminating the worst observations, using various data scrubbing rules. There is, however, no discussion, or apparently, consideration of the field inspection of data, verification with on-site personnel, or a major review of data records. Rather, we are subjected to extensive and arbitrary data scrubbing—which clearly eliminates the outliers, some of which may be quite relevant.

⁹² USPS Initial Brief III-49.

The Postal Service indicates on data scrubbing that:

Finally, a sense of perspective must be maintained. Dr. Neels' Table 4 showed a staggering total of 267,141 observations remaining after Dr. Bradley's scrubs. Tr. 28/15611. This certainly is an exhaustive data set by any standard.⁹³

The above statement is irrelevant. The amount of data is not at issue; what is at issue is the accuracy of the data and the possible elimination of the consideration of outliers based on mechanical approaches which eliminate outliers because they are outliers—even though they may provide significant information.

The Postal Service also complains about Dr. Smith's comments:

OCA witness Smith claims that Dr. Bradley's data scrubs need further analysis, as they raise a number of questions. Dr. Smith's testimony on this point is unenlightening, as he merely lists a number of questions he has, but makes no attempt to discuss either their relevance or what evidence in the record has been or could be brought to bear in answering them . . .⁹⁴

OCA submits that actual inspection of the data would be a good start in lieu of mechanical, rule of thumb data elimination. The Postal Service itself apparently does not have faith in the accuracy of the database, as quoted from reports by postal inspectors. We are assured that the comments of the postal inspectors are known to be not based on scientific accuracy—and that in any case the comments apply to the larger installations.⁹⁵ However, larger installations are just the types of installations likely to be candidates for major investment programs. Activities at larger installations may provide insight on the effects of capital investments, and on the demand for labor as TPH changes. Accordingly, we are left further wondering about the usefulness of the underlying data base.

We are further assured that in the data rich environment that data can be eliminated, but even after elimination there will be plenty of data left. So, for example,

⁹³ USPS Initial Brief III-61.

⁹⁴ USPS Initial Brief III-60.

⁹⁵ USPS Initial Brief III-53.

witness Bradley eliminates all of the sites for which three years worth of data are not available. This accordingly eliminates any site that has undergone major automation efforts in the past three years. So not only is witness Bradley's study a short term study, but it is apparently potentially lacking in relevant data for modernized and automated facilities.

Finally, the conclusions of witness Bradley's study are not robust. Witness Bradley cites a variety of ways in which regressions were run on the same data in the same way, with small variations. For these cases, the conclusions are largely repetitive, seldom differing much from regression to regression, for there is actually very little difference in the way in which he analyzes the data. However, when looked at in terms of a pooled model, a cross-sectional model, or even a model with all of the data present, the conclusions are that the study is far from robust. Witness Bradley focuses on the fact that some of witness Neels' mail processing activities have lower variabilities than his do; it should also be noted that some of witness Neels' mail processing activities have higher variabilities than those presented by witness Bradley. However, the numbers are irrelevant at this point. It is clear that there are a number of different results. The conclusions are not robust.

6. The study should be rejected.

This brief has focused on some of the Postal Service comments and provided additional amplification when necessary. Witness Bradley's study is far from complete. Methodologically there are theoretical, estimation, and database problems. The study does not meet the criteria for implementation as outlined by Dr. Bonbright. The actual variability of mail processing costs is unknown; estimates have ranged from very low to well over 100 percent.

However, it is clear that additional work is needed to address the major study deficiencies. The Postal Service has indicated that this is the first time such a step has been undertaken. It is now time to move forward with a better second step. The burden of proof is on the Postal Service. Pending resolution of the variability issue it is appropriate to apply 100 percent variability previously applied. The arguments,

methodologies, and conclusions are so contradictory among witnesses that the Commission must turn to a common sense approach. There may very well be economies of scale in mail processing; however, it is far from clear that these economies of scale occur at the activity level. In fact, scale economies may very well occur at the management, research, administrative, or other levels. Accordingly, absent a completed study, the choice of 100 percent variability is the most prudent at this time.

V. THE DEGEN METHOD FOR DISTRIBUTING MIXED
MAIL PROCESSING COSTS SHOULD BE USED EVEN IF
THE COMMISSION DECIDES TO REJECT THE BRADLEY
VOLUME VARIABILITY ANALYSIS AS OCA
RECOMMENDS

The Postal Service's expressed preference for having both of its proposed new costing methodologies (i.e., the Bradley and Degen analyses) adopted by the Commission is understandable. However, the Commission should not be misled by Postal Service assertions that important economic principles would somehow be violated if one were to be recommended without the other. OCA has clearly established in the preceding section of the reply brief that witness Bradley's volume variability analysis is so deeply flawed that it must be rejected. However, the Degen distribution method has easily withstood the ineffectual challenges of intervenors.⁹⁶ Moreover, the Degen approach is far higher on the evolutionary ladder of distribution methods than LIOCATT, which is the default distribution method if the Degen approach is rejected.

A statement made by witness Christensen, the Postal Service defender of the inseparability of the Degen and Bradley analyses, is relevant and highly significant: *"[W]hile the IOCS data can identify the proportion of mail processing workhours spent on various activities, it cannot identify the underlying causal relationships needed to establish volume variability."*⁹⁷ This suggests that the bond between the distribution key and the volume variability analysis is not nearly as close or strong as the Postal Service would have the Commission believe. Ultimately, it is information from IOCS that witness Degen must use⁹⁸ (and which LIOCATT uses, too) to distribute component 3.1 costs to the subclasses. Therefore, if the Commission takes the action urged by OCA, i.e., rejecting the Bradley analysis, the question remains open whether it is preferable to employ LIOCATT to distribute mixed-mail costs or the Degen procedure. The Degen procedure is manifestly superior.

⁹⁶ See e.g., arguments presented in Initial Brief of Alliance of Nonprofit Mailers, American Business Press, Coalition of Religious Press Associations, Dow Jones, Magazine Publishers of America, National Newspaper Association, McGraw-Hill, and Time Warner.

⁹⁷ Tr. 34/18218 (USPS-RT-7 at 2) (emphasis added).

⁹⁸ USPS Initial Brief at III-90.

Witness Degen analyzes mail processing cost incurrence at a much greater level of detail than has ever been previously attempted. Rather than distribute mixed-mail costs within broad CAG/Basic Function categories (as LIOCATT does), witness Degen distributes them (in his words) at a "much finer and more accurate level," "using pool-specific keys."⁹⁹ According to UPS witness Sellick¹⁰⁰, witness Degen's method is an

improvement . . . in two important respects: (1) it links the distribution of mixed-mail and "overhead" (not handling mail) costs with the operational characteristics of mail processing; and (2) it incorporates information on the contents of items (e.g., sacks, bundles, trays, and pallets) and containers more completely into the distribution of mixed mail costs.

It would be folly to disregard the valuable body of information witness Degen has developed merely because of an unsubstantiated assertion that the Bradley and Degen analyses are somehow inextricably connected.

In its initial brief, the Postal Service cites the testimony of witness Panzar for support of its assertion.¹⁰¹ A review of the cited portion of Dr. Panzar's testimony reveals that it furnishes no support for the position that the Bradley and Degen analyses are in any way linked immutably. Dr. Panzar's testimony merely presents a proof that volume variable costs are economic marginal costs. The selection of a distribution key is a separate process. If the Degen distribution key is determined to be superior to LIOCATT, then it is a simple matter to include it in the formulae presented at page 23 of USPS-T-11. Certainly nothing in the Panzar testimony prevents the Commission from adopting the Degen distribution key while rejecting the Bradley volume variability analysis. Likewise, witness Bradley makes no statements at pages 5-6 of his

⁹⁹ Tr. 12/6294-95 (interrogatory OCA/USPS-T12-17).

¹⁰⁰ Tr. 26/14163 (UPS-T-2 at 4).

¹⁰¹ USPS Initial Brief at III-11, citing USPS-T-11 at 21-23.

testimony—USPS-T-14¹⁰²—that are an impediment to using the Degen distribution (even if the results of the Bradley analysis are rejected).

Indeed, if the Commission decides (as OCA recommends) that the Bradley analysis is unusable, the Commission will necessarily revert to its longstanding theory that mail processing (component 3.1) costs are 100 percent volume variable. This premise is not the product of an econometric procedure utilizing a specific database. Therefore, the Commission has complete freedom (and, in fact, the duty) to employ the best possible distribution method available to it on the record—clearly, the Degen method. There is no reason to believe that LIOCAT, which is based on broad functional groupings, is in any way a better “match” to the premise of 100 percent variability than a distribution key that allocates costs at the activity level. Therefore, even if the Commission rejects witness Bradley’s volume variability analysis, it has the freedom and the duty to use the Degen distribution method.

The Postal Service relies on the rebuttal testimony of witness Christensen to persuade the Commission that “the portions of the mail processing cost methodology presented by witnesses Bradley and Degen [cannot] be divorced.”¹⁰³ Although witness Christensen made a valiant effort to stick to his story during oral cross-examination, when pressed hard by the Chairman, he was forced to admit that it is “not impossible” to use one without the other. Chairman Gleiman asked witness Christensen how to resolve the dilemma of what the Commission should do if it had a “problem” with one, but not the other. Witness Christensen replied that, while his preference is *“to have a consistent new framework . . . [and] to be very cautious about using either without the other . . . [he] wouldn’t say it’s impossible to do it in a way that makes sense.”*¹⁰⁴

¹⁰² USPS Initial Brief at III-11 cites this portion of the Bradley testimony. Witness Bradley refers to an article he co-authored with Jeff Colvin and Marc Smith, i.e., “Measuring Product Costs for Ratemaking: The U.S. Postal Service,” in *Regulation and the Evolving Nature of Postal and Delivery Services*, M. Crew and P. Kleindorfer. There is no discussion in this article either that would obligate the Commission to employ the inferior LIOCAT distribution method over the Degen distribution method.

¹⁰³ Tr. 34/18220 (USPS-RT-7 at 4).

¹⁰⁴ Tr. 34 at 18288-89 (emphasis added).

OCA finds support for its position that the Bradley and Degen methods can be divorced in the testimony of MPA witness Cohen,¹⁰⁵ who takes the position that:

Pending the development of more complete cost information, cost distributions should generally be done as they have in the past

In the same testimony, witness Cohen extols the virtues (as she sees them) of the Bradley analysis.¹⁰⁶ Likewise, Time Warner witness Stralberg recommends the acceptance of witness Bradley's estimates of volume variability,¹⁰⁷ but harshly criticizes witness Degen's distribution methodology. Witnesses Cohen and Stralberg urge the Commission to follow a course of action precisely the opposite of that urged by OCA (i.e., they would reject the Degen distribution but retain the Bradley analysis). However, they share OCA's view that the two methods can be divorced.

The internal contradictions in the Postal Service's position are exposed when one compares its policy for determining the attributable costs (and distributing such costs) within cost segment 14, for example, to its position on the attribution/distribution of component 3.1 costs. The Postal Service introduced its new system for distributing purchased transportation costs—TRACS—in Docket No. R90-1; but the Service found it unnecessary to perform a new econometric analysis utilizing the cost driver cubic foot-miles.¹⁰⁸ The Service apparently found that no important economic principles were violated by divorcing the distribution of purchased transportation costs from the

¹⁰⁵ Tr. 26/14026 (MPA-T-2 at 2).

¹⁰⁶ E.g., *id.* at 14039-41 (15-17), respectively.

¹⁰⁷ Tr. 26/13817 (TW-T-1 at 3).

¹⁰⁸ Witness Bradley testifies that cubic foot-miles are the cost driver for purchased highway transportation in USPS-T-14 at 6.

attribution of such costs and to omit the attribution procedure altogether from its case in R90-1.¹⁰⁹

In conclusion, the Commission should reject the Bradley volume variability analysis for the reasons set forth in the previous section of the reply brief, but should distribute 100 percent of component 3.1 costs using witness Degen's methodology.

¹⁰⁹ Another type of discrepancy in Postal Service costing—between the identification of accrued and attributable costs in cost segment 7—is addressed by Advo witness Crowder in response to NOI No. 3 at Tr. 29/16185 and in her rebuttal testimony. Tr. 34/18307-08 (ADVO-RT-1 at 4-5). She states that:

[T]he mismatch between the LTV modeled load time and elasticities and the STS estimate of accrued load time necessarily results in a substantial overstatement of attributable load time costs

Although OCA does not agree that attributable load time costs are overstated, we do agree that there is a "mismatch," as described by witness Crowder. The Postal Service professes to be a fervent adherent to integrated costing procedures, but accepts the STS/LTV inequivalence with nonchalance.

VI. CONTRARY TO POSTAL SERVICE CLAIMS, THE
UPDATED COST MODEL SUCCESSFULLY
REPLICATES POSTAL SERVICE COSTS.

The Postal Service claims that “witness Thompson’s cost model does not replicate Postal Service costs.”¹¹⁰ More specifically, the Service argues that the updated version of the Commission’s cost model is a failure because it substitutes data rather than replicates Postal Service data.¹¹¹ Apparently, the Postal Service envisions the Commission, the OCA, or other interested parties producing Postal Service data out of thin air. As stated in OCA’s initial brief,

Ideally, parties to a case would examine all Postal Service data. However, the reality of time constraints and limited resources forces participants such as the OCA to rely on the Postal Service’s integrity to accurately report their Base Year data.¹¹²

The OCA accepted the integrity of the Postal Service’s “Manual Input Requirement” data and is criticized by the Postal Service for doing so. Given these criticisms, the only conclusion that can be drawn is that the Postal Service believes interested parties could develop and install data collection systems in postal facilities.

The Postal Service presents three feeble arguments for why the OCA’s updated Commission cost model is a failure. In summary, the criticisms are: 1) witness Thompson manually edited Postal Service data, 2) witness Thompson used data from the Postal Service’s “A Report,” and 3) witness Thompson used programs external to the Commission’s cost model to replicate Postal Service data and reports. Each of the three Postal Service points will be discussed in turn.

¹¹⁰ Initial Brief of the United States Postal Service at III-192.

¹¹¹ *Id.*

¹¹² Office of the Consumer Advocate Initial Brief II at 219.

A. Postal Service Electronic Filing Errors Required Witness Thompson To Manually Correct Postal Service Data.

Contrary to Postal Service claims, data presented in the hard copy version of the Postal Service's "Manual Input Requirement" was not replicated in the electronic version it filed. In those instances where the Postal Service's electronic and hard copy data did not agree, witness Thompson manually corrected the Commission's updated cost model data file to accurately reflect the hard copy data.¹¹³

Claims that the OCA cost model does not properly replicate Postal Service costs because data corrections were manually input into a data file are without merit. The Postal Service cannot expect its costs to be replicated when it provides erroneous data.

B. The OCA's Updated Cost Model Is Not Invalidated By Witness Thompson's Use of Postal Service Component 61.

Special delivery messengers salary components 58 and 59 appear in the following two Postal Service reports: USPS-T-5, Workpaper A, "Manual Input Requirement" and the "A Report." The sum of Postal Service components 58 and 59 is Postal Service component 61. Component 61 only appears in USPS-T-5, Workpaper A, the "A Report." Witness Thompson uses component 61 as a distribution key rather than add components 58 and 59 and then use the resulting sum in its updated cost model. The Postal Service's declaration that the updated cost model fails to replicate Postal Service costs because witness Thompson used Postal Service component 61 rather than have the cost model add two components is illogical. The updated version of the cost model has proven time and time again that it can add any two numbers and generate a correct result.

C. The Updated Cost Model Is Not Invalidated By Reliance On Multiple Programs To Replicate Postal Service Results.

The OCA's replication of the Postal Service's base year costs begins with acceptance of Postal Service data as presented in USPS-T-5, Workpaper A, "Manual

¹¹³ Tr. 19E/9772-9780.

Input Requirement.” To facilitate data input, the OCA developed and introduced a SAS-based program (PREPROC.SAS, see OCA-LR-3) that easily converts Postal Service data into a format compatible with the Commission’s cost model.

The SAS program was developed in response to the Postal Service’s continuing failure to provide data in a format readily usable by the Commission. Prior to OCA’s solution, the base year data was manually keyed into a file prior to running the Commission’s cost model. The data input process was laborious. The OCA’s avoidance of this road block significantly reduces the man-hours required to update and begin running the Commission cost model. Moreover, the SAS-based program enhances the Commission cost model and reduces the potential for manual input errors.

Given the wealth of Postal Service computer programmers operating in a mainframe environment, the Postal Service’s cost model is frequently updated as new costing methodologies are launched. Also, due to the numerous computer programmers, the Postal Service’s cost model generates a wealth of detailed reports. The Commission must rely on personal computer resources to replicate Postal Service results. Witness Thompson used EXCEL to prepare information for use in the Commission cost model. Then, to generate reports similar to those prepared by the Postal Service, witness Thompson imported data from the updated cost model into EXCEL.

The Postal Service criticizes witness Thompson’s use of EXCEL spreadsheets. Since the EXCEL spreadsheets are not automated, the Postal Service claims that the “hard coded” information and reports are further evidence of the updated cost model’s failure.¹¹⁴ Belittling the updated cost model because the Commission operates in a personal computer environment and relies on multiple resources to replicate Postal Service mainframe applications is puzzling.

¹¹⁴ Initial Brief of The United States Postal Service at III-192-195.

D. Difficulties Surrounding Use Of The Postal Service's Cost Model Have Been Removed.

As reiterated numerous times, the purpose of witness Thompson's testimony and library references was to explain the procedures she followed to update the Commission's version of the Postal Service cost model.¹¹⁵ Though witness Thompson successfully updated the Commission cost model and replicated Postal Service cost data, the Postal Service claims the model is a failure because she has not mastered the multitudinous Postal Service cost nuances.¹¹⁶ Her testimony and library references have rolled away the rock that kept intervenors from examining the deep dark Postal Service cost caverns. Surely, the Postal Service is not worried that educating intervenors on cost methodology will prove to be anything but enlightening.

¹¹⁵ Tr. 20/10496-97.

¹¹⁶ Initial Brief of the United States Postal Service at III-193-4.

VII. INSURANCE ISSUES

In OCA's Initial Brief II, Section IX., OCA argued that the Commission should require the Postal Service to stop its deceptive insurance practices before approving the substantial insurance fee increases being sought. In its Initial Brief, the Postal Service acknowledged OCA's insurance information concerns as expressed in Docket No. MC97-5¹¹⁷ and stated that "the Postal Service will consider such concerns in managing its insurance product, [but that] the Postal Service does not believe that they should affect its classification and fee proposals in this proceeding."¹¹⁸

OCA notes that the Commission, in its Opinion and Recommended Decision in Docket No. MC97-5, concluded that in the pack-and-send context, "the insurance and indemnification features of the proposed packaging service require alteration to satisfy the standards of fairness and equity in §3623(c)(1)."¹¹⁹ Therein, the Commission recommended "that the special packaging service be altered to include a limited guarantee for users against damage resulting from defective packaging."¹²⁰ The Commission added: "For this reason, the Commission urges the Postal Service to inform potential users of the packaging service fully of the limits of coverage provided under the guarantee we recommend, and how it dovetails with additional purchased insurance."¹²¹

OCA wishes to emphasize that the insurance deception problem extends outside the pack-and-send context.¹²² Requiring the Postal Service to provide consumers with insurance information does not intrude upon Postal Service management prerogatives, as explained in Section IX.B. of OCA's Initial Brief II. The Postal Service now makes a number of consumer-oriented publications available, and it is quite possible the dearth of insurance information is merely an oversight on its part. However, requiring the Postal

¹¹⁷ Postal Service Initial Brief at VI-23, n.19.

¹¹⁸ *Id.* at VI23.

¹¹⁹ PRC Op. MC97-5 at 18.

¹²⁰ *Ibid.*

¹²¹ *Id.* at 19.

¹²² OCA Initial Brief II at 221, *et seq.*

Service to hand out an insurance brochure will have only a *de minimis* effect on window service operations.¹²³

¹²³ OCA Initial Brief II at 227.

VIII. RATE ISSUES

A. The Postal Service's Post Office Box Fee Proposal Is More Problematic For What It Portends Than What It Does.

In OCA's Initial Brief II, many reasons are presented as to why the Commission should recommend the post office box classification and fee changes proposed by OCA witness Callow. Those arguments need not be repeated here. Suffice it to say that OCA's proposal is the only proposal before the Commission that would restructure post office box fee groups and move toward a more cost-based fee schedule, thereby creating a more fair and equitable fee schedule by better aligning fees with costs.¹²⁴ OCA Initial Brief II at 127. Nevertheless, several additional comments are warranted.

1. The Postal Service's claims that its post office box fees are better aligned with costs are weak.

The Postal Service attempts to make more out of its simple change in fees than is warranted. It claims that "witness Needham proposes to improve the alignment of fees with costs . . ." USPS Brief at VI-25. This is the equivalent of putting a suit on a pig. The improvement is virtually meaningless.

The Postal Service's proposal maintains the post office box fee group structure with its excessive averaging of postal rental costs within existing Fee Groups C and D. OCA Initial Brief II at 134. At best, attempting to "dress-up" this portion of the existing fee structure with new fees can only be said to marginally improve the alignment of fees with the costs, but within a flawed framework.

2. The Postal Service's proposed "limited regrouping" requires a strong Commission response

The Postal Service congratulates itself for signaling in the abstract its intentions to regroup offices based upon cost and demand considerations. USPS Brief at VI-34-35. It

¹²⁴ Pages 49-52 of this Reply Brief contains OCA's suggested DMCS language implementing the classification and fee changes for post office boxes proposed by witness Callow. The proposed DMCS definitions of Groups A and B are based upon the testimony of Postal Service witness Marla Larson in Docket No. R90-1, i.e., USPS-T-22 at 9-10.

is only in this proceeding, however, that the Postal Service's intentions came to life in the form of a "hypothetical" and "limited regrouping" in the rebuttal testimony of witness Kaneer—ideas that heretofore had no real substance. Clearly, the OCA cannot be faulted for expressing surprise at finally seeing some flesh on the bones, especially since the ideas bore no relationship to the direct testimony of witnesses Needham and Lion.

More importantly, however, the Postal Service claims that "the DMCS . . . provides the Postal Service with limited flexibility to apply fees as costs and demand considerations warrant." USPS Brief at VI-33. Apparently, by Postal Service design, the DMCS does not define post office box fee groups. USPS Brief at VI-36. Despite this fact, it is only reasonable that, having litigated and come to an understanding of the Postal Service's post office box fee groups in this and previous proceedings (e.g., Docket No. MC96-3), interested parties and the Commission would expect that the current fee structure is formal and permanent until such time as the Postal Service would propose a new classification scheme.

It now appears that the Postal Service intends to reconfigure the post office box fee structure unilaterally, without formal Commission approval, via *Federal Register* notice. USPS Brief at VI-36. Issues that were litigated and resolved by the Commission, i.e., fairness and equity, the number of boxholders affected, estimated changes in revenues, and changes in fee groups as described by Postal Service witnesses, would be reopened and subject to change at the sole discretion of the Postal Service.

The Commission should rectify this situation in its opinion and recommended decision in this proceeding. Whatever the fees recommended for post office boxes (whether witness Callow's or witness Needham's), the Commission should incorporate the relevant fee group definitions from the DMM, or otherwise define Fee Groups A-D, in the DMCS.

**REQUESTED CHANGES IN THE DOMESTIC MAIL CLASSIFICATION
SCHEDULE FOR POST OFFICE BOXES**

The OCA requests that the Commission recommend the following changes to the Domestic Mail Classification Schedule (DMCS) to reflect the post office box classification and fee changes proposed by OCA witness Callow. The text added to the DMCS proposed herein follows the new section numbering scheme proposed by the Postal Service in its Request. OCA's proposed additions to text of the classification and fee schedules are underlined, and proposed deletions are stricken.

922.23 Fee Groups

922.231 Post office box fee groups categorize post offices by the type of carrier delivery service offered by post offices. In addition, fee groups defined in 922.232 and 922.233 are based upon the Cost Ascertainment Group (CAG) designation of the post offices. Fee groups defined in 922.234 and 922.235 are based upon designated very high cost and high cost ZIP Code areas, respectively, in addition to the type of carrier delivery.

922.232 A post office that provides city carrier delivery at any of its administered facilities, and has the following CAG designations, applies Group C-I, C-II or C-III fees as identified, except as provided in 922.234 and 922.235.

<u>CAG Designation</u>	<u>Fee Group</u>
<u>A, B, C, D</u>	<u>C-I</u>
<u>E, F, G</u>	<u>C-II</u>
<u>H, J, K, L</u>	<u>C-III</u>

922.233 A post office that does not provide city carrier delivery but provides only rural carrier or highway contract carrier delivery at any of its administered facilities, and has the following CAG designations, applies Group D-I, D-II or D-III fees as identified, except as provided in 922.234 and 922.235.

<u>CAG Designation</u>	<u>Fee Group</u>
<u>A, B, C, D</u>	<u>D-I</u>
<u>E, F, G</u>	<u>D-II</u>
<u>H, J, K, L</u>	<u>D-III</u>

922.234 A post office that provides city carrier delivery at any of its administered facilities, and is defined by certain designated very high cost ZIP Codes, as prescribed by the Postal Service, constitutes an exception to the fee group definitions in 922.232 and 922.233. Group A fees apply.

922.235 A post office that provides city carrier delivery at any of its administered facilities, and is defined by certain designated high cost ZIP Codes, as prescribed by the Postal Service, constitutes an exception to the fee group definitions in 922.232 and 922.233. Group B fees apply.

Schedule SS-10—Post Office Boxes and Caller Service

I. Semi-annual Box Fees¹

Box Size²	Fee Group					
	A		B		E³	
	Proposed	Current	Proposed	Current	Proposed	Current
1	\$37.50	\$ 24	\$32.50	\$ 22	\$0	NA
2	55.00	37	47.50	33	0	NA
3	95.00	64	80.00	56	0	NA
4	165.00	121	145.00	109	0	NA
5	275.00	209	242.50	186	0	NA

Box Size²	Fee Group					
	C-I		C-II		C-III	
	Proposed	Current	Proposed	Current	Proposed	Current
1	<u>\$28.00</u>	<u>\$ 20</u>	<u>\$23.00</u>	<u>\$ 20</u>	<u>\$20.00</u>	<u>\$ 20</u>
2	<u>40.50</u>	<u>29</u>	<u>33.50</u>	<u>29</u>	<u>29.00</u>	<u>29</u>
3	<u>73.00</u>	<u>52</u>	<u>65.00</u>	<u>52</u>	<u>52.00</u>	<u>52</u>
4	<u>120.00</u>	<u>86</u>	<u>99.00</u>	<u>86</u>	<u>86.00</u>	<u>86</u>
5	<u>201.00</u>	<u>144</u>	<u>165.50</u>	<u>144</u>	<u>144.00</u>	<u>144</u>

Box Size²	Fee Group					
	D-I		D-II		D-III	
	Proposed	Current	Proposed	Current	Proposed	Current
1	<u>\$12.00</u>	<u>\$ 6.00</u>	<u>\$9.00</u>	<u>\$ 6.00</u>	<u>\$7.50</u>	<u>\$ 6.00</u>
2	<u>20.00</u>	<u>10.00</u>	<u>15.00</u>	<u>10.00</u>	<u>12.50</u>	<u>10.00</u>
3	<u>36.00</u>	<u>18.00</u>	<u>27.00</u>	<u>18.00</u>	<u>22.50</u>	<u>18.00</u>
4	<u>53.00</u>	<u>26.50</u>	<u>40.00</u>	<u>26.50</u>	<u>33.00</u>	<u>26.50</u>
5	<u>83.00</u>	<u>41.50</u>	<u>62.50</u>	<u>41.50</u>	<u>52.00</u>	<u>41.50</u>

¹ A customer ineligible for carrier delivery may obtain a post office box at no charge, subject to administrative decisions regarding customer's proximity to post office.

² Box Size 1 = under 296 cubic inches; 2 = 296-499 cubic inches; 3 = 500-999 cubic inches; 4 = 1000-1999 cubic inches; 5 = 2000 cubic inches and over.

³ Group E post office box customers subject to these fees are those not eligible for carrier delivery.

II. Semi-annual Caller Service Fees

<i>Fee Group</i>	<i>Fee</i>	
	Proposed	Current
A	\$275	\$250
B	\$275	\$240
C	\$275	\$225
D	\$275	\$225

III. Annual Call Number Reservation Fee

<i>(all applicable Fee Groups)</i>	\$40	\$30
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B. The Postal Service's Criticism Of Witness Collins' Reasonable And Prudent Treatment Of Library Rate Mail Has No Merit.

The Postal Service calls witness Collins' proposal for library rate mail "extreme".¹²⁵ However, it is the *Postal Service's* rate proposal which deserves that description. Witness Adra's rates will result in the virtual elimination of library rate mail—a category of mail deemed worthy of special status by Congress and awarded preferential treatment by statute. The Postal Service claims that witness Adra, through his rate design, did all he could to ameliorate the impact of the huge rate increases he proposes for library rate mail. The OCA does not see elimination of a preferred subclass as an appropriate method of ameliorating outrageous rate increases.

On brief, the Postal Service admits to the very problems with library rate costs which OCA witness Collins' testimony addresses. A section of the brief is even titled "Library rate is a small subclass with large coefficients of variation".¹²⁶ The brief further states:

The relatively small volume of mail in the Library Rate subclass has led to relatively high coefficients of variation (c.v.'s) surrounding the estimates of the IOCS-reported mail processing costs for that subclass. This circumstance, and the increased unit costs reported for Library Rate mail, has been the subject of several Presiding Officer's Information Request (POIR) items. In response to POIR No. 2, Item 1, Postal Service witness Degen, noted that, because Library rate only reports 80.4 tallies per dollar of unit cost, they "suffer from some instability due to the small volume and the nature of the IOCS sampling procedure." Indeed, witness Degen's testimony reports that the c.v.'s relative to Library rate mail are nine percent, which is higher than the c.v.'s reported for several other subclasses' estimates.

This is precisely why witness Collins made her proposal.

The Postal Service states, "The record is clear that witness Collins' comparison of the 'volatility' of costs of Classroom publications and Library rate is inapt".¹²⁷ The OCA

¹²⁵ Initial Brief of the United States Postal Service at V-213 and V-213 through 220 generally.

¹²⁶ *Id.* at 214, citations omitted.

¹²⁷ *Id.* at 216.

firmly believes the comparison is apt. However, even if it were not, the facts surrounding the volatility of the costs of library rate mail remain undisputed and unchanged by the Service's claim.

The claims that witness Collins "stubbornly maintains that the Classroom treatment serves as the precedent for her proposed cost substitution"¹²⁸ and that she says that the situations are "directly parallel" are totally in error. She never says the situations are parallel. In contrast, she specifically states that they are different. See witness Collins' testimony at Tr. 24/13093. Also, rather than citing the treatment of classroom as specific precedent, she states: "*Guidance for solving the Library Rate problem (at least in the short term) may be found in the history of various actions taken regarding another relatively small subclass, Classroom.*"¹²⁹

The Postal Service strains to try to demonstrate that special rate cannot serve as a proxy for library rate because the subclasses are so different and do not share the same cost-causing characteristics. It contends that this is not an "apples" to "apples" comparison. However, it is clear from Postal Service data and testimony that these two subclasses are far more similar than they are different. Even though a small portion of special rate is containerized by presort level, their content is the same and they share *very similar cost causing characteristics*. How else could the Service expect virtually all of library rate to be able to migrate to the special rate subclass upon imposition of its spectacularly high proposed rates?

Contrary to its claim on brief, in reality, it is the Postal Services' proposal which would have "seriously detrimental rate results for the Library rate subclass".¹³⁰ Witness Collins' use of special rate per piece costs is a reasonable proxy for the defective IOCS costs of library rate mail and demonstrates prudent judgment. Her proposal should be recommended by the Commission.

¹²⁸ *Id.* at 218.

¹²⁹ Tr. 24/13088. Emphasis added.

¹³⁰ USPS Brief at V-219.

IX. CRITICISMS OF RAMSEY PRICING ARE UNPERSUASIVE AND MISUNDERSTAND OCA'S POSITION

The Initial Briefs of the Newspaper Association of America (NNA) and Hallmark Cards, Incorporated both argue against the use of Ramsey prices in postal ratemaking. Neither position is persuasive, and it appears there is some miscomprehension of OCA's position on Ramsey pricing. It is true that rigid application of Ramsey prices may not be appropriate, since such pricing may not serve perfectly all the broad goals of the Postal Reorganization Act. But it is also true that (1) departures from marginal cost prices are needed to raise money to meet the break-even requirement of the Act, and (2) there is no way to depart from marginal cost prices for raising money that will cause less loss in welfare than to use Ramsey prices. When marginal cost prices are not available, Ramsey prices replace them as the prices that minimize welfare loss. So as other goals are pursued through departures from Ramsey prices, it is reasonable to think of the cost of those departures as the added welfare cost that will be imposed by meeting the other goals. The fact that there may be other goals in no way diminishes the value and importance of Ramsey prices in setting postal rates.

NNA claims that elasticities developed for the purpose of forecasting mail volumes are inappropriate for use in Ramsey pricing. But these elasticities are exactly the ones that are wanted, contrary to NNA's complaint. It is correct to say that not all cross-price elasticities can be estimated at non-zero levels, but this is a reality forced on us by the limits of empirical estimation. The best answer to this difficulty is better data and estimation, which can be said of any pricing model dependent upon elasticity estimates.¹³¹ This is not just a Ramsey pricing problem. In any event, the present estimates appear to be quite sound, and serve as a basis for forecasting large and important magnitudes. Cross-elasticities with private sector substitutes or complements

¹³¹ As the Commission has noted, "[t]he reliability of the forecasts is a major Commission concern in every general rate case." PRC Op. MC95-1 at IV-82. A general discussion of the problems of estimation follows this quoted statement. See, e.g., the Commission's discussion of problems perceived with regard to the reliability of forecasts made under the Postal Service's model. *Id.* at IV-91 *et seq.*

are desirable, though admittedly hard to work with. They have been considered in some previous cases and did not have gigantic effects.

The Hallmark position on Ramsey prices also is excessively negative. Hallmark claims that the use of Ramsey prices is not legally permissible, that implementation of Ramsey prices is not feasible on the present record, and that Ramsey prices would have undesirable consequences for senders and recipients of mail. However, postal pricing is an evolutionary process, and it is likely that any well-reasoned, appropriate use of Ramsey pricing would be acceptable to the courts; it is inappropriate to take the extreme position that any use of Ramsey prices is illegal. In fact, as discussed below, Ramsey prices may be seen as quite consistent with the ratemaking criteria set forth in 39 U.S.C. § 3622(b).

The Hallmark brief also takes issue with the representation of welfare loss that lies behind Ramsey prices. The main objection arises from the value to the recipient of mail, which Hallmark essentially argues has been overlooked. But one has to assume that this value to the recipient has been considered by the mailer, since it is the mailer who now pays for the service. Assuming the mailer considers the value to the recipient would eliminate the claim that there is an externality.

The value to the recipient is pretty clearly considered in the case of, say, birthday cards, since either they are usually exchanged or the mailer knows the recipient very well. Thus, the mailing party can more easily imagine the pleasure of the recipient. It may be possible to treat the value to the recipient separately and to devise a way for the recipient to pay, and thereby give effect to this valuation and even to measure it. Hallmark should make a proposal if this factor is so important. Charging that others fail to solve this claimed problem of measuring the value to the recipient is empty criticism until some solution to this very difficult problem of reflecting it is provided.

Hallmark also argues that there are unpriced values that are enjoyed directly by the mailer, or purchaser of postal service, citing Dr. Erickson's testimony on behalf of the Greeting Card Association.¹³² The unpriced value for greeting cards has to do with maintaining family relationships. It is not clear that these pleasure benefits should be

¹³² Tr. 25/13151.

priced, since they are added benefits. But in any case, a host of claims can be made about the unpriced benefits of this or any category of mail¹³³ and it would be very difficult indeed to sort them out and compare them in any meaningful way.

Although it may be reasonable to assume that mailers take into account the value of mail to the recipient, they may not fully consider the added concern that is expressed in the statute for the educational, cultural, scientific and informational value (“ECSI value”) to the recipient of mail matter.¹³⁴ To reflect the ECSI value requires judgment. If serving such goals means departing from Ramsey prices, the efficiency cost of doing so should be considered, and Ramsey prices permit a measurement of the added welfare loss that will be experienced. Ramsey pricing is an analytical tool, not a utopian principle that must blindly be striven towards.¹³⁵ It is also possible that Ramsey prices can be deemed to reflect the ECSI value to the recipient.

Other criteria in section 3622(b) also are not at all inconsistent with Ramsey prices. For example, the ninth criterion, “such other factors as the Commission may deem appropriate,” clearly could include Ramsey pricing. Criterion seven—calling for simplicity of structure for the entire schedule and simple, identifiable relationships between the rates or fees charged the various classes of mail for postal services—can still be applied. Indeed, the costs of such simplicity can even be calculated if reaching a desired level of simplicity requires departures from Ramsey prices.

Criterion six, the degree of preparation of mail for delivery into the postal system performed by the mailer and its effects upon reducing Postal Service costs, simply recognizes the worksharing possibility, which also can be priced according to Ramsey principles. The fifth criterion—the available alternative means of sending and receiving

¹³³ Indeed, family relationships can be maintained by sending gifts through, e.g., parcel post or Priority Mail.

¹³⁴ 39 U.S.C. § 3622(b)(8).

¹³⁵ Nor is the ECSI value of greeting cards the only ECSI value to be considered. It is hard to conjure up a mailing that does not have at least minimal ECSI value. And some classes of mail may have substantially more ECSI value than greeting cards, e.g., if Aunt Minnie sends a chemistry set via parcel post or Priority Mail to her nephew on his birthday instead of sending him a birthday card. Even a mortgage bill can be said to have an ECSI value to the recipient – compare the value to a family of remaining secure in their home because the mortgage was paid on time to the value of receiving a greeting card.

letters and other mail matter at reasonable costs—is what cross-elasticities can help to assess and which are part of Ramsey prices.

The fourth criterion—the effect of rate increases upon the general public, business mail users, and enterprises in the private sector engaged in the delivery of mail matter other than letters—can be seen as calling for moderation of sudden changes in rates. Ramsey pricing principles can be applied in such fashion. The fourth criterion also can be seen as reflecting the implicit Ramsey pricing concern for the profitability of competing suppliers of mail services.

The third criterion—the requirement that each class or type of mail service bear the direct and indirect postal costs attributable to that class or type plus that portion of all other Postal Service costs reasonably assignable to such class or type—is obviously met by Ramsey prices because such prices favor pricing above costs. The second criterion—the value of the mail service actually provided each class or type of mail service both to the sender and recipient—is directly related to Ramsey pricing, since “value of service” is traditionally seen as being reflected in price-elasticities of demand. Finally, the first criterion—the establishment and maintenance of a fair and equitable schedule—is in no obvious way inconsistent with Ramsey pricing.

If postal pricing is to be based on the facts available in the record, there is a role for Ramsey pricing. Reasonable positions, such as that of the American Postal Workers Union Initial Brief, recognize the power of Ramsey principles for setting prices when marginal cost prices will not yield sufficient revenue. It is possible that a different pricing framework in which recipients pay some of the cost of mail services would offer advantages, but that is a substantial change from the current system. Without such a framework, it is not possible to consider it.

In conclusion, OCA recommends consideration of Ramsey pricing principles during the ratemaking process, but not slavish adherence to such principles. Under the existing ratemaking framework, though, raising additional revenues is done with the least welfare loss using Ramsey principles. That is why Ramsey prices offer such a good starting point for developing postal prices. One can then see what the welfare loss

implications are for each departure from Ramsey prices. Hallmark's characterization (and criticism) of "Ramsey pricing as canonical"¹³⁶ misses these essential points.

RESPECTFULLY SUBMITTED,

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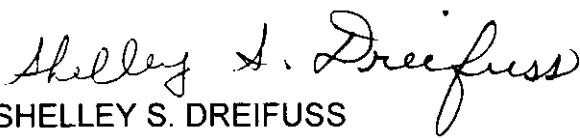
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¹³⁶ Hallmark Initial Brief at 31.

CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document upon all participants of record in this proceeding in accordance with section 12 of the rules of practice.


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